separately in the context of a Part 69 review,[22] and has no place in the instant proceeding.

BASELINE ISSUE 3: CHANGES IN PRODUCTIVITY FACTORS OR RATE LEVELS

Baseline Issue 3a: Whether the productivity factor used to compute the LEC price cap indices should be changed; in addition, or in the alternative, whether a one-time change in the LECs' price cap indexes should be required.

The Commission should both increase the LEC price cap productivity factor to 5.9% and require a one-time decrease in the LECs' price cap indexes.[23] It should not, however, adopt an automatic adjustment to the price cap formula for changes in interest rates. Instead, the Commission should consider such adjustments in subsequent periodic price cap plan reviews.

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[22] Several parties have petitioned the Commission to undertake a comprehensive review of the access structure. With such proposals pending, it would be premature for the Commission to modify the price cap structure prior to resolution of the appropriate composition of the LEC access services structure. See, e.g., Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Public Notice DA 93-481, released April 27, 1993; NARUC Petition for Notice of Inquiry Addressing Access Issues, Public Notice DA 93-847, released August 3, 1993; Amendments of the Rules to Reform Interstate Access Charges: USTA Petition for Rulemaking, Public Notice (Report No. 1975), released October 1, 1993; and Ad Hoc Telecommunications Users Committee Petition for Rulemaking: Amendment of Part 36 and Part 69 of the Commission's Rules to Effect Comprehensive Reform of the Access Charge System, filed April 15, 1994.

[23] This one-time change should be allocated among the baskets on the basis of relative basket revenue. This method of apportionment is consistent with the method that the Commission has used to allocate exogenous changes such as sharing. 1992 Annual Access Order, CC Docket No. 92-141, 7 FCC Rcd 4731, 4732-4, (Com. Car. Bur. 1992).

In the LEC Price Cap Order, the Commission selected the productivity factor of 2.8%, based on two productivity studies it conducted.[24] A short-term study examined LEC productivity since the initiation of access charges. In that study, the Commission computed overall LEC common line and traffic sensitive rates from the 1984 tariff year through the 1990 tariff year,[25] adjusting the actual rates charged for exogenous cost changes and demand stimulation. By comparing changes in these rates to changes in the GNP-PI over the same period, the Commission calculated that a productivity factor of 3.43% would have been necessary in the Balanced 50/50 common line formula to reach the same average level of LEC earnings as was achieved historically under rate of return regulation.[26]

In its long-term study, the Commission examined telephone service price index data from 1928 through 1989 to estimate LEC productivity.[27] It determined

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[24] LEC Price Cap Order, 5 FCC Rcd at 6797-98. The Commission actually adopted two productivity factors, 3.3% and 4.3%, reflecting historical productivity measures of 2.8% and 3.8%, plus a CPD of 0.5%. Optional election of the higher productivity factor would allow the carrier to retain a greater level of profits. (Id., at 6801) For ease of reference, MCI refers in its discussion only to the lower factor, which the majority of carriers have selected. Any recommendations MCI offers for the 3.3% factor apply to the higher factor as well, maintaining the same 1% differential and relative sharing ranges.

[25] It included each of these years, even though the trend line of rate changes showed a marked change after the 1984 tariff year. Id. at 6797.

[26] Id. at 6896, Appendix C, A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity, Chart Prod, Page 1 of 1.

[27] Id. at 6798.

that a productivity factor of 2.25% in the Balanced 50/50 common line formula was necessary to replicate long term historical results.[28]

The Commission explicitly recognized that the productivity levels calculated in these two studies represented not "specific numerical results," but "likely outcomes within a range of possible values."[29] Noting the relative strengths and weaknesses of these two studies,[30] the Commission set the initial LEC productivity factor at 2.8%. The Commission described this factor as "a conservative minimum figure within the range between the two studies."[31]

There was ample justification for the Commission to have selected a productivity factor from the high end of the range represented by its two

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[28] Id.

[29] Id.

[30] The strengths of the short-term study were: (1) it adjusted for the exogenous effects of both cost and demand changes; (2) it covered the most recent period, and thus was potentially the most relevant for assessing trends in the next four years; and (3) it focused directly on the interstate switched access market. Its limitations were: (1) it could examine only a few data points which were during a period when no recession occurred; (2) it excluded special access; (3) its results were extremely sensitive to the inclusion of the 1984 tariff year data point; and (4) it required many complex adjustments to the raw data to account for the exogenous changes since divestiture. Id.

The strengths of the long-term study were: (1) it looked at data over several decades including both recession and expansion times; (2) it provided results less subject to economic variations and short-term events; (3) it was consistent with other long-term studies already in the record; and (4) it included the effects of special access. Its drawbacks were: (1) it required assumptions to derive interstate access productivity from the total industry numbers; (2) it did not adjust for exogenous changes since divestiture or for changes in profits over time; and (3) it weighted pre-divestiture experience more heavily than post-divestiture experience. Id.

[31] Id.

productivity studies, when it originally determined the factor.[32] The outstanding profits enjoyed by the LECs under price caps, even in a slow economy, substantiate the Commission's characterization of its choice of the productivity factor as conservative. Not only was the Commission cautious in its selection of the 2.8% productivity factor, but the range of reasonable productivity factors from which it made its selection was itself conservative. This is because the Commission included a data point in its short term study that significantly lowered the reasonable range of estimated productivity factors established by that study.[33]

Specifically, the Commission included the 1984 tariff year data point in the analysis that supported its adoption of the 2.8% factor, a decision that was controversial at the time.[34] While noting that use of the data point made the trend regression model fit less well, the Commission decided nonetheless to include it in order to incorporate all post-divestiture data in its analysis. The Commission adjusted the data underlying that observation to compensate for the problems that it was able to identify. Even with these adjustments, the data point still lay outside the trend of the other post-divestiture years. Had the Commission excluded the that data point, the productivity factor would have been at least 2.0% higher.[35]

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[32] LEC Price Cap Order, 5 FCC Rcd at 6896.

[33] Id. at 6892-94.

[34] Id. at 6798.

[35] Although the Commission did not report a productivity factor for the Balanced 50/50 formula using data that excluded the 1984 data point, the study in the Supplemental Notice found that an increase of over 2.5% in the productivity factor for the originally proposed Balanced 50/50 formula was necessary if that

Correcting the analysis in the short term study to remove this data point would result in an upper bound of 5.43%. Adding to that factor a consumer productivity dividend ("CPD") of 0.5%, this study supports a productivity hurdle as high as 5.93%. Thus, the short-term productivity study measuring LEC productivity under rate of return regulation from 1984 to 1989 would support a productivity factor of 5.9%. MCI recommends that the Commission should raise the productivity factor in the LEC price cap plan to 5.9%.

There is ample reason to discount the 1984 data point and rely solely on the short-term post-divestiture productivity study. Almost four years into the price cap plan, it is clear that the Commission was overly conservative in its choice of productivity factor. Most of this period has been characterized by a weak economy as reflected in relatively slow interstate demand growth.[36] Yet, the LECs have realized high profits. Moreover, they garnered these profits during a period in which both interest rates and cost of capital declined steeply. The LECs have prospered, achieving rates of return well in excess of the 11.25% level at which rates were initialized.[37] Although the Commission anticipated that the efficiencies

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1984 data point were excluded. See Supplemental Notice of Proposed Rulemaking, CC Docket No. 87-313, 5 FCC Rcd at 2176, 2326-27 (1990) ("Supplemental Notice").

[36] In 1990, the last year that LECs operated under rate of return regulation, total CCL minutes of use demand grew 10.77% over the level in 1989. Demand each year under price caps has grown at a much slower rate: 6.7% in 1991, 6.68% in 1992, and 5.83% in 1993.

[37] The price cap LECs as a whole achieved earnings of 12.85% in 1993, 12.31% in 1992, and 11.48% in 1991.

encouraged by the incentives of price caps would result in higher profit levels, it also stated that it did not expect that most carriers would be able to achieve earnings that required 100% sharing.[38] The majority of price cap LECs, however, have realized returns in 1993 that require sharing at the 50% level, and some have attained earnings high enough to require 100% sharing. These results confirm that the Commission's characterization of its productivity factor as conservative was indeed correct.

Alternatively, if the Commission accepts MCI's recommendation to revise the common line formula by adopting a per line approach, the productivity offset should be 5.5%. The short term study originally found that an offset of 2.97% would be necessary using a per line cap on common line rates. Adding 2.0% to that number would rase the offset to 5.0%. With the CPD, the total offset would be 5.5%. Not only are LEC earnings wholly out of line with any reasonable relationship to their cost of capital, but ratepayer benefits under the plan have been lilliputian relative to the size of shareholder benefits. To date, shareholder benefits have eclipsed ratepayer benefits by nearly $900 million.[39] (This amount represents shareholder benefits net of any ratepayer benefits received, e.g., price

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[38] LEC Price Cap Order, 5 FCC Rcd at 6804.

[39] This amount represents the difference between the price cap LECs' achieved earnings in 1991, 1992, and 1993, and the amount they would have earned under rate of return regulation with the authorized return set at 11.25%. The LECs' actual earnings result from the rates they charge their customers. These rates include any below cap pricing, the effects of the CPD, or sharing amounts. As such, earnings above 11.25% are total LEC benefits less the benefits the price cap plan required them to give to ratepayers.

decreases, the CPD, etc. If the Commission does not act in this review to more equitably balance LEC and ratepayer interests, this amount will grow again next year to a level well over $1 billion. While the theory of incentive regulation requires the LECs be given the opportunity to earn amounts greater than under rate of return, what has happened in the first three years of the price cap plan is out of all proportion to the Commission's stated intention of balancing ratepayer and shareholder interests.

Increasing the productivity factor to 5.9% will not attenuate future LEC efficiency incentives. In its AT&T Price Cap Order,[40] the Commission expressed concern that prospective adjustments to the productivity factor, if based solely on the companies' past performance, might reduce the incentive to cut costs in the future. Adjustment to the productivity factor now, however, should not be construed as an attempt to recapture productivity gains that will dampen future LEC cost-cutting efforts. Indeed, the potential for an increased productivity factor was anticipated by the LECs themselves. For example, Bell Atlantic recognized that an increase in the LECs' productivity factor might be warranted if a "large number of LECs were to earn high returns."[41] The Commission should raise the level of the original productivity factor because experience under the price cap plan has underscored that the selection was far too conservative. Increasing the

[40] AT&T Price Cap Order, 4 FCC Rcd at 3141-43.

[41] Bell Atlantic Comments, filed May 7, 1990, in CC Docket No. 87-313, at 9-10.

productivity factor will strike a better balance between LEC and ratepayer interests without hampering the LECs' ability to earn reasonable profits.[42]

The LECs may argue that ratepayers also have benefitted from increased LEC productivity through the sharing mechanism. MCI, however, believes that the LECs have been manipulating sharing by booking additional costs in the fourth quarter, thereby lowering or altogether eliminating their sharing obligations and depriving the ratepayers of the rewards they are due.[43] The LECs' propensity to manipulate their reported earnings renders the sharing mechanism an inadequate method of flowing to ratepayers their share of the benefits gained from increased LEC productivity.[44] The Commission can ensure that ratepayers receive some benefit from the apparently high productivity the LECs have achieved if it increases the productivity hurdle.[45]

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[42] One percentage point change in the productivity factor is worth approximately 0.4 percentage points on the rate of return. AT&T Price Cap Order, 4 FCC Rcd at 3214, n. 1485. Thus, this increase in the productivity factor will lower the LECs' rate of return only about 1.25%.

[43] See Table 1.

[44] In addition, rates that were depressed due to sharing caused the LECs' reported earnings levels to be even lower, thereby reducing their sharing obligations in the next year. The Commission currently is considering whether the LECs have understated their earnings levels. See Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, 8 FCC Rcd 4415 (1993).

[45] There are two ways by which the Commission can achieve an increased productivity hurdle. First, it can raise the productivity factor because the LECs have achieved greater productivity than was reflected in the original hurdle. Alternatively, the Commission can increase the CPD to ensure that the ratepayers receive their rightful share of the LECs' productivity increases.

In sum, the Commission acknowledged at the outset of LEC price cap regulation that it had selected a low estimate of the LECs' productivity factor. The LECs now have achieved high earnings using that factor, despite such adverse conditions as relatively low demand growth and a relatively weak economy. In addition, the LECs have fared even better than their reported earnings would indicate, because they routinely exhibit unusually high expenses in the fourth quarter. In light of all these factors, MCI urges the Commission to increase the productivity factor to 5.9%. Any productivity factor below that level would represent a very conservative choice, based on the productivity evidence and performance evidence currently before the Commission.

The Commission's recognition of the need to increase the productivity factor on a prospective basis suggests that a corresponding adjustment to historical LEC earnings is also necessary. By agreeing to a going-forward adjustment, the Commission implicitly acknowledges that the LECs have overearned during the initial price cap period because, among other factors, it set the original productivity hurdle too low. Since this portion of LEC earnings did not result from LEC efficiency, but was derived instead from a mis-calibrated productivity factor, the Commission should adjust the price cap indexes or risk the LECs unjustly retaining benefits derived from the price cap plan at the expense of their ratepayers.

Because the LEC price cap indexes reflected a productivity factor of 3.3% instead of 5.9%, the indexes are at least 2.6% too high for each year in which the lower productivity factor was used. The LECs have made three annual price cap filings, and must, therefore, reduce their price cap indexes by 7.5%.[46]

In addition to this one-time adjustment, MCI recommends that the Commission also adjust the price cap index formula to reflect the current lower cost of capital.[47] This adjustment should take the form of both a recalibration of the sharing mechanism (so that the cost of capital is at the midpoint of the sharing zone) and an adjustment to the price cap index to reflect the lower cost of capital.[48] At each subsequent price cap review, the Commission should establish the current cost of capital and reset the sharing mid-point and boundaries accordingly.

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[46] To make this adjustment, the LECs should multiply their current price cap indexes by a factor that is the product of $(1 - 0.026 * w_i)$, $i = 1991, 1992, 1993$, for each of the three annual access filings since price caps for LECs began. If the w_i for each of those three years were 0.98, the factor would be $(1 - 0.026 * .98)^3$, or 0.9255. Thus, the LECs would have to lower their price cap index by about 7.5% in order to correct for the understated productivity factor the Commission adopted in 1990.

[47] As discussed in greater detail below, the Commission should adjust the price cap formula to reflect the cost of capital at the time of each subsequent price cap review. Most LEC debt is long-term, fixed-rate debt, so changes in the short term rates have little effect on the total cost of LEC debt. In addition, the LECs' cash flow is sufficient to fund most, if not all, of their capital expansion. In fact, the LECs' use of 40% of their cash flow for purposes other than infrastructure investment indicates that their cash flow is more than sufficient to fund their capital expansion. Further, the LECs will generate about $100 billion of depreciation charges over the next seven years to fund any infrastructure enhancements. Any new debt the LECs will incur will be needed primarily to retire current outstanding debt as it matures. Since the exchange of new for old debt occurs only gradually, there is no need to adjust the price cap indexes for changes in interest rates.

[48] The Commission adopted this same recalibration mechanism at the initiation of the price cap plan, when it required the LECs to reduce their July 1, 1990 rates to reflect the change in cost of capital from 12.0% to 11.25%.

<u>Baseline Issue 3b</u>: Whether the price cap LECs' profit levels are reasonable under the current LEC price cap plan in light of the price cap goal that higher profits are intended to be the reward for attaining increased efficiencies.

If the Commission had set the productivity factor at the proper level and the LECs' cost of capital had remained constant, then the profits that the LECs achieved (adjusted for fourth quarter expense bookings) would have fallen within the range the Commission anticipated when it adopted the price cap plan. MCI avers, however, that the conditions during the original price cap term do not support the level of profits the price cap carriers accrued. Specifically, the LECs' cost of capital has fallen to 9.54%,[40] and the LECs easily achieved artificially high earnings by easily scaling the Commisison's 3.3% productivity hurdle. Taken together, these two components require a one-time adjustment in the LECs' price cap indexes to lower rates to correctly adjust the price cap formula on a going-forward basis.

<u>Baseline Issue 3c</u>: The method the Commission should use to determine a revised and reasonable productivity factor.

MCI's views on this issue are discussed in Baseline Issue 3a.

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[40] <u>See</u> Appendix A.

BASELINE ISSUE 4: SHARING AND LOW-END ADJUSTMENT MECHANISM

Baseline Issue 4a: Whether and how the sharing and low-end adjustment mechanisms should be realigned with capital costs.

The Commission set the initial sharing and low end adjustment limits based on the cost of capital reflected in the starting price cap rates. To the extent the LECs' cost of capital has changed, it is necessary to adjust the sharing and low end adjustment ranges accordingly. Only then can the sharing mechanism perform its intended function, i.e., giving LECs an opportunity for higher earnings than under rate of return regulation, but not unlimited earnings potential.

MCI believes the best way to ensure that price cap rates are reasonable is to maintain the relationship between a measure of LEC cost of capital and the midpoint and boundaries of the sharing zone. In this way, both LECs and ratepayers equitably benefit from the incentives of a price cap plan. In Appendix A, MCI demonstrates that the LECs' current cost of capital is 9.54%. The study in Appendix A updates the Discounted Cash Flow ("DCF") study that the Commission performed when it set the rate of return at 11.25%. Since 1990, there have been reductions in the cost of debt and the cost of equity, and changes in the composition of the LECs' debt. Repeating the study using revised data on these factors results in a current cost of capital of 9.54%.

In setting the cost of capital at 11.25%, the Commission included three adjustments to its DCF results that together raised the cost of capital by about 1%. These adjustments are no longer necessary. First, the Commission adjusted its findings to allow for variations in cost of capital among the companies. Use of this adjustment guarantees that the LECs will on average achieve an excessive return. In addition, the Commission adjusted for the "cellular effect," a claim by price cap LECs that projected earnings used in the DCF analysis did not accurately reflect potential cellular earnings. This adjustment is unnecessary because the market now has had ample experience on which to base its expectations of cellular earnings. Finally, the Commission increased the authorized cost of capital to allow funds for infrastructure development. This adjustment also is unnecessary because the LECs have sufficient resources with which to make these investments.

Accordingly, the Commission should require the LECs to recalibrate the point around which the sharing range is set to reflect the current cost of capital. Further, the low end adjustment level should be set at 8.54%, the 50% sharing level should be set at 10.54%, and the 100% sharing level should be set at 14.54%.[50] Since the cost of capital now is below the Commission's current low end adjustment trigger, failure to adjust the sharing limits would guarantee that LECs would earn well above their cost of capital, without any efforts by the LECs to increase their productivity.

MCI does not advocate moving the midpoint and boundaries of the sharing and low end adjustment zone in lockstep with the Part 65 cost of capital determination for rate of return carriers. The Commission currently is considering

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[50] For companies that elect the higher productivity factor, the starting points for the 50% and 100% sharing levels would be 11.54% and 15.54%, respectively.

creating a streamlined process for calculating cost of capital for these companies.[51] Following a different schedule and characterized by streamlined measurement techniques for rate of return carriers, this rulemaking proceeding has no bearing on the issue of calibrating sharing zones for price cap carriers. While the Commission should act expeditiously to resolve cost of capital issues for rate of return carriers, these two matters are discrete and the Commission should resolve them independently.

Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.

The Commission originally adopted the sharing and low end adjustment mechanisms for LECs because it was "difficult to determine a single, industry-wide productivity offset that [would] be perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time."[52] MCI believes that market and economic risk and uncertainty continue to exist, and that as the LECs pursue individual courses, the likelihood of earnings deviations among them increases. For these reasons, MCI supports retention of price cap sharing mechanisms for the LECs.

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[51] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Process, Notice of Proposed Rulemaking, 7 FCC Rcd 4688 (1992).

[52] LEC Price Cap Order, 5 FCC Rcd at 6801.

With respect to the low end adjustment mechanism, however, the price cap plan already contains protections that more than adequately guard LECs against confiscatory rates. First, LECs retain the ability to file above-cap rate increases, in effect declaring that the price cap formula is demanding productivity improvements that they are unable to produce.[53] While these rates would probably be suspended and investigated, the outcome of such filings likely would be either that the LECs would revert to rate of return regulation, or the Commission would create a new price cap index with a lower productivity offset for the LECs. In addition, to the extent that an individual LEC experienced special circumstances that resulted in the price cap index producing confiscatory rates, a waiver of the price cap rules also would serve as a safety net. Thus, in a plan where LECs already are protected from confiscation by "belts and suspenders," a low end adjustment mechanism is unnecessarily redundant. Its elimination does not materially add to the risks that price cap LECs face under incentive regulation.

MCI is confident that its recommended 5.9% productivity factor is more appropriate than the current 2.8% productivity factor for the industry as a whole. While there may be deviations by individual LECs from the industry norm, ratepayer interests will continue to be protected by the sharing mechanism, while shareholders are protected by the ability to file above-cap tariffs, if that becomes necessary.

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[53] 47 C.F.R. § 61.49(e)(permitting an exhaustive cost analysis of the carrier's rates) (1992).

Regardless of the Commission's decision to retain the low-end adjustment mechanism, modification to the plan is required to avoid the perverse incentives created by the sharing and low-end adjustment mechanism. Specifically, the Commission must fashion a remedy to curtail the LECs' inclination to overstate their fourth quarter expenses. Table 1 compares LECs' earnings levels through the third quarter with their earnings for the entire year for each year since 1990, the last year before price cap regulation was instituted.[54] In 1990, the average decline in LEC profit levels between the third and fourth quarter was 0.20%. In each of the price cap years, that average has been higher due to fourth quarter booking of large costs.[55] This pattern holds true for most of the individual companies.[56]

This practice of booking large expenses in the fourth quarter seems to be an attempt to manipulate the sharing rules. MCI has reiterated this concern since the LECs submitted their first annual price cap tariff filing.[57] Repetition of this

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[54] These data were compiled from the companies' ARMIS 43-01 reports. Prior to 1990, the data reported in each quarter were not cumulative, so no comparison with years prior to 1990 is possible.

[55] This trend appears more pronounced in 1993 because the Common Carrier Bureau required carriers to modify their accounting of accruals. See Responsible Accounting Officer ("RAO") Letter 24, DA 94-268, released March 24, 1994. The effect of this change is that reported LEC expenses are reduced, resulting in even higher profit levels.

[56] Only two carriers in 1992 and three in 1991 did not exhibit such increases. Final ARMIS data for all carriers were not available for the fourth quarter of 1993 in time to be incorporated into these comments.

[57] See MCI Petition to Reject or, in the Alternative, to Suspend and Investigate, 1992 Annual Access Charge Tariff Filings, pp. 7-12.

behavior indicates that LEC reporting of higher expenses is not merely a statistical aberration. Instead, the LECs seem to be adjusting either their year-end spending or accounting[38] to achieve a targeted earnings level. The LECs may contend that they incur these higher expenses (e.g., early retirement programs) to allow them to have lower costs in the future, but there is no promise that such savings will actually occur. Instead, the LECs will have achieved guaranteed funding of their short term expenses (in the form of lowered or forestalled sharing obligations), while shifting onto the ratepayers the risk that no future savings from increased efficiency ever will develop.

The Commission must adopt a method to place a check on this LEC behavior. One alternative would be to require that one-time accounting adjustments for the fourth quarter be declared on or before September 15 of each year, and that the LECs file a justification and explanation of each adjustment, along with its likely earnings impact. The filing could be placed on public notice to allow ratepayers and other interested parties the opportunity to comment or to suggest alternative ways to account for the expense. An affirmative Commission approval would be necessary in order to book the expense. This type of procedure would

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[38] Part of the reason for the decline in earnings in the fourth quarter is one-time charges for such activities as employee force reductions. The Commission's recently released RAO Letter 24 requires the companies to book these one-time charges, but not charge them against earnings until the cash is actually spent. This requirement should mitigate the accounting effects of lowering the rate of return in the fourth quarter with respect to work force reductions.

act as a check on LEC discretion to revise earnings in its favor just prior to the point in time when sharing obligations are fixed.

BASELINE ISSUE 5: COMMON LINE FORMULA

Baseline Issue 5a: Whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges.

The Commission originally adopted a Carrier Common Line ("CCL") formula that permitted LECs and IXCs to share equally in the benefits of demand growth because it believed that LECs and IXCs alike were capable of influencing interstate usage of interstate common lines.[59] MCI continues to contend that the Balanced 50/50 formula unduly minimizes the contribution that IXCs make to common line growth stimulation, while overstating the LEC's ability to do so. For these reasons, MCI urges the Commission to revise the common line formula to employ a method that more clearly reflects the relative contributions the IXCs and LECs make to stimulate demand growth.

The Commission's selection of the Balanced 50/50 formula responded to LEC contentions that (1) they "directly provide some services that generate interstate CCL minutes of use"; (2) they have installed new technologies that improve network facilities and operations; and, (3) their advertising "encourage[s] calling."[60] Experience has shown that these claims are not compelling. First, the

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[59] LEC Price Cap Order, 5 FCC Rcd at 6793-95.

[60] Id.

percentage of foreign exchange and interexchange intraLATA usage that the LECs generate compared to the IXCs' demand is immaterial.[61] Next, the service outage reports since the inception of price caps show no significant change in network reliability,[62] suggesting that the network upgrades have no impact on demand. In fact, as noted below, demand growth has decreased. Finally, the current separations rules require IXCs to pay a disproportionately high percentage of LEC marketing expenses.[63] Assessment of LEC claims that they should be rewarded for demand stimulation resulting from their own marketing efforts must be tempered by the fact that IXCs already fund these marketing programs. The stimulation effect of these programs, if any, should be credited to their source -- the IXCs -- who have already reluctantly paid for LEC marketing plans in their access rates.

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[61] The price cap LECs have interexchange revenue of only about $70 million compared with estimated AT&T Basket 1 revenues of approximately $18 billion.

[62] As the Commission notes, the majority of service outages continue to be due to fiber cuts caused by construction activity. Notice, at para. 28.

[63] MCI believes that an excessive level of LEC marketing expenses is embedded in the initial price cap rates. The Commission has never ruled on the controversy concerning the appropriate allocation of LEC marketing expenses in its Part 36 rules. MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and the Establishment of a Joint Board, 2 FCC Rcd 5349 (1987)(referring to the Joint Board a permanent resolution of the marketing cost allocation issue.) The LECs argued that access rates should reflect a high level of marketing expenses because their marketing programs stimulated interstate demand. MCI viewed the situation differently: IXCs pursue their own marketing efforts to increase interstate minutes of use. Any marketing expense component of LEC access charges should reflect only the cost associated with encouraging IXCs to use LEC services. Since these services are monopoly in nature, any marketing expense allocation that includes costs other than those associated with carrier relations are unnecessary and excessive.

More significantly, usage data during the first period of price cap regulation show that LECs are incapable of affecting interstate demand growth. When the Commission changed courses and adopted the Balanced 50/50 formula, it concurrently adjusted the productivity factor upward by 0.50%, based on a demand figure of 8.0% growth.[64] Under the Balanced 50/50 formula, LECs receive half of the benefit of demand growth only when demand growth is at exactly that level. If demand fails to reach that level -- as has been the case during the last four years[65] -- LECs receive less than half the benefit of demand growth. Since the LECs were incapable of stimulating demand to the level anticipated in the Commission's Balanced 50/50 formula, it is difficult to sustain an argument that they deserve half the benefit of demand stimulation.[66]

Even had the LECs illustrated that they were capable of increasing demand -- and they did not -- they could not possibly do anything to stimulate demand indirectly that could make up for the direct demand-stifling effect of the higher access rates that result from the Balance 50/50 common line formula. Further, any LEC retention of benefits from demand stimulation would suppress common line demand by keeping CCL rates higher than they would have been otherwise. This

[64] LEC Price Cap Order, 5 FCC Rcd at 6890.

[65] See n. 36, supra.

[66] By comparison, MCI was building its market share, offering innovative new services to stimulate demand, and advertising those services extensively. During the period the LECs have operated under price caps, MCI has increased its market share from 15.3% to 18.4% despite the declining rate of overall growth in interstate demand. Long Distance Market Shares: Fourth Quarter, 1993, released April 15, 1994.

phenomenon effectively dampens the very demand stimulation that is the source of common line usage growth in the first place.[67] On the other hand, if the IXCs receive all of the benefits of common line usage growth, the resulting decrease in access charges would allow the IXCs to pass on the savings to ratepayers, resulting in the beneficial demand stimulation that the Commission sought.

Baseline Issue 5b: What method the Commission should use to cap common line charges.

The per-line formula that the Commission originally intended to adopt provides the correct incentives to both the LECs and the IXCs, and the Commission should adopt it now. The per line formula recognizes that the IXCs -- and not the LECs -- have the ability and market-based incentives to stimulate demand growth. Most important, the per-line formula does not unnecessarily enrich the LECs for interstate usage growth over which they have no measurable influence, but instead rewards the IXCs for the role they play in reducing end users' long distance rates. In the long distance market, competition has had a significant effect on fueling decreases in the IXCs' rates. For example, under price caps, reductions in AT&T's rates reflect not just the flowed-through reductions in LEC access charges, but the full 3.0% productivity hurdle that price caps requires it to

[67] LEC Price Cap Order, Separate Statement of Commissioner Ervin Duggan, 5 FCC Rcd at 6861.

overcome.[58] The Commission must change the formula to accurately reflect the role the IXCs play in stimulating demand growth.

Baseline Issue 5c: How the Commission's adoption of a per-line charge should affect possible changes in the productivity factor or the composition of baskets.

While substitution of the per-line formula for the Balanced 50/50 formula would result in an adjustment in the productivity factor, it should have no affect on the composition of the baskets. Specifically, if the Commission adopts the per-line formula, it will be necessary also to lower the productivity factor by approximately 0.50%. In the Commission's short-term productivity study, it calculated the different productivity factors necessary to reach the same result as achieved under rate of return regulation while substituting different common line formulas. Based on historical demand data, the Commission calculated the unitary productivity factor to be 2.97% under the per-line scenario, and 3.49% under the formula it adopted.[59] The difference between these two numbers represents an adjustment to the productivity factor that needs to be reversed if the Commission embraces the per-line formula.

No additional changes to the productivity factor would be needed with respect to the composition of baskets. Because the Commission picked a unitary

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[58] Robert E. Hall, Long Distance: Public Benefits from Increased Competition, October 1993, p. 24.

[59] LEC Price Cap Order, 5 FCC Rcd at 6896.

productivity factor for all access services (rather than a separate factor for each basket), access elements can shift among baskets without effecting the relative weights of the elements underlying the productivity calculation. This is because the productivity factor the Commission selected reflected a mix of traffic sensitive and non-traffic sensitive elements. Rearranging the elements among baskets does not alter this relative mix. Thus, no adjustment to the productivity factor is necessary to reflect individual basket composition.

Baseline Issue 5d: The incentives generated by the current Balanced 50/50 formula, the per line formula or other possible formulas.

The Balanced 50/50 formula provide incentives that are antithetical to the Commission's goals. That is, as discussed supra, while the LECs have little ability to influence demand, the Balanced 50/50 formula gives them significant incentive to stimulate demand above 8.0% growth. Conversely, the IXCs have the greater power to affect demand, but they lose half the benefit of demand stimulation above the 8.0% growth mark. While it is certainly to the IXCs' overall benefit to increase interstate usage, to the extent that the Balanced 50/50 formula bestows upon the LECs benefits which the IXCs created, LECs receive an unearned and unwarranted benefit from higher CCL rates relative to a per-line formula. Replacement of the Balanced 50/50 formula with the per-line formula would establish the proper relationship between incentives and abilities to affect demand.

BASELINE ISSUE 6: EXOGENOUS COST CHANGES

Baseline Issue 6a: Whether the number of cost changes currently eligible for exogenous treatment under price caps should be reduced.

Exogenous changes are currently identified in §61.45(d)(1) of the Commission's rules and include (1) completion of the amortization of depreciation reserve deficiencies; (2) Commission approved or mandated changes in the Uniform System of Accounts ("USOA"); (3) changes in the Separations Manual; (4) changes to the LTS and the Transitional Support Fund obligations; (5) the reallocation of investment from regulated to nonregulated activities; (6) Commission approved or mandated tax law changes and other extraordinary exogenous cost changes; (7) retargeting the price cap index to adjust for sharing or low end adjustments; and (8) inside wire amortization.[70] MCI believes that continual efforts of the LECs to declare additional categories of costs exogenous largely have eroded the savings in administrative burdens promised by the price cap plan.[71] Because exogenous cost treatment permits LECs to flow through those cost to ratepayers, MCI is concerned that the theory and practice of exogenous costs must be more precisely framed to prevent ad hoc decisions about exogenous

[70] 47 C.F.R. § 61.45(d)(1) (1992).

[71] See OPEBs Order, 8 FCC Rcd 1024 (1993); 1993 Annual Access Order 8 FCC Rcd 4960 (Com. Car. Bur. 1993); and Petition for Waiver of the Commission's Rules to Recover Network Depreciation Costs, Order, 9 FCC Rcd 377 (1993) ("United Depreciation Order"). These cases consumed massive amounts of LEC, staff, and intervenor resources.

treatment from further diminishing the very incentives that price caps was intended to create.

MCI suggests that the theory of exogenous treatment be restated to include only those Commission-ordered changes that result in a shift in costs between the interstate and intrastate jurisdictions or between regulated and non-regulated operations. Next, to avoid the constant pressure by the LECs to expand the exogenous cost definition, specific exogenous costs should be selected that are consistent with the revised theory, and the Commission should give exogenous treatment to only those costs explicitly identified, absent a rule waiver. MCI's proposals are more explicitly addressed in Baseline Issue 6b, infra.

It is critical that the FCC re-evaluate the criterion that it will use to select which costs will be treated exogenously. The incentives of price cap regulation can be engendered best by minimizing the number of cost categories that are accorded exogenous treatment. That is, the fewer opportunities that LECs have to pass through to their ratepayers any increases (or decreases) in costs, the greater the LECs' incentives both to reduce costs and to increase profits. As the Commission itself states, "the designation of any cost change as exogenous removes the incentive for efficiency that is the principal goal of price caps."[72]

The Commission should delete certain categories of costs from the lists of costs that have received exogenous treatment in the past. Several of these categories have expired, and there is no need to retain them in the rules. The

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[72] United Depreciation Order, 9 FCC Rcd at 387.